April 1, 2009

MEMORANDUM

TO: Senator John Arthur Smith, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Economist

SUBJECT: LFC Report of Investment Performance – FY2009 Second Quarter

Investment Performance Highlights:

- Because of the continued global economic downturn, all of the major state investment agencies suffered significant losses throughout the second quarter of FY09. Total asset values for all funds declined $5.7 billion from the previous quarter and have now fallen $11.4 billion or 30.1 percent throughout the past twelve months. The Public Employee Retirement Association (PERA) suffered the biggest percentage and dollar value losses shedding more than $4.3 billion or 32.7 percent over the last year.

- All of the state investment agencies drastically underperformed their quarterly policy benchmarks in the second quarter and for the year. The State Investment Council (SIC) managed Land Grant Permanent Fund (LGPF) is the only fund which remains above its five year policy benchmark by 40 basis points (bps)[1].

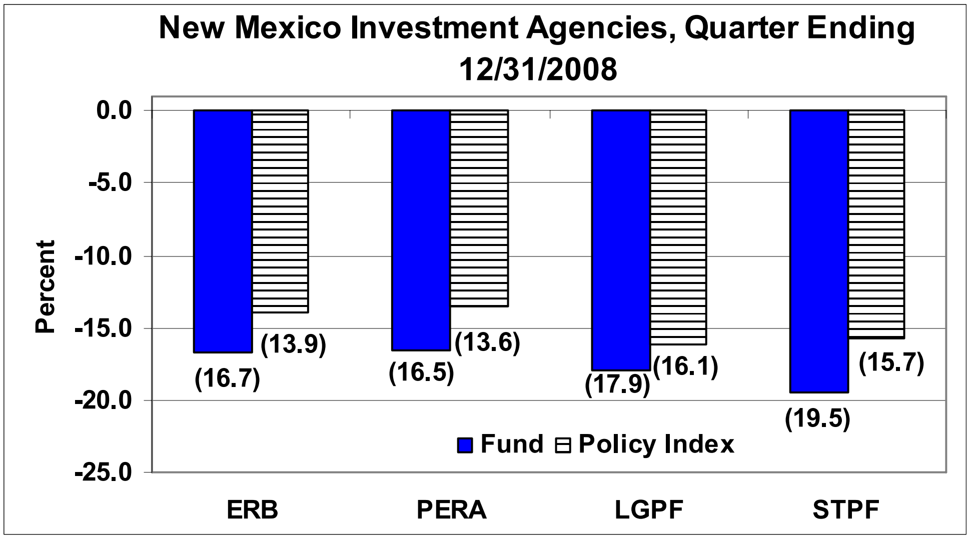
- The poor returns delivered thus far by the pension funds raise significant concerns as to their funding status. Both funds need to meet an 8 percent average return in order to adequately fund future retirement payments. Currently, PERA and the Educational Retirement Board (ERB) have ten year returns of 3.19 percent and 1.8 percent respectively.

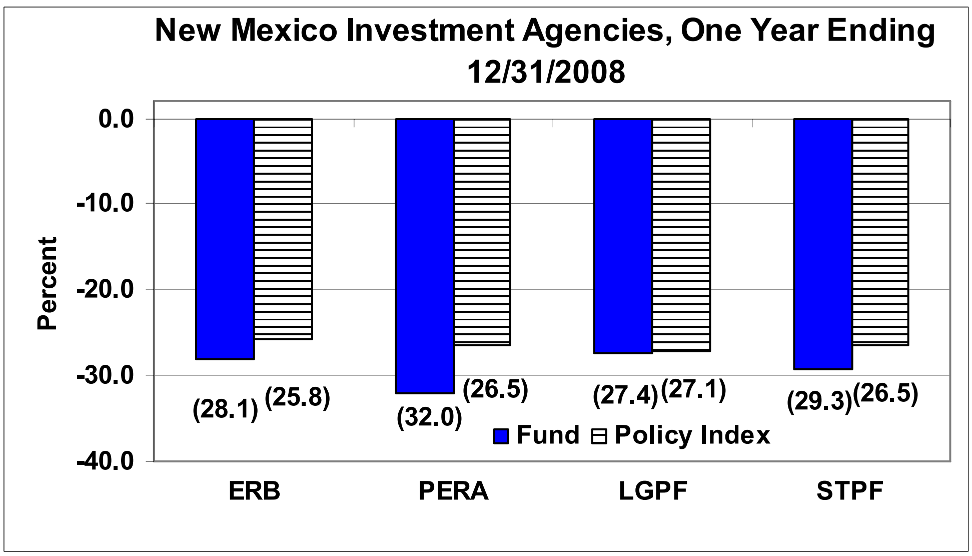
- Both SIC and ERB suffered problems with various alternative investments throughout the quarter including exposure to Bernard Madoff, who has since confessed to running a $50 billion ponzi scheme. The funds' combined exposure to the scandal makes up approximately $28.25 million through external managers Austin Capital and CT Preferred Investors. SIC also suffered a setback with the bankruptcy of the Albuquerque Airplane manufacturer Eclipse Aviation. The SIC had approximately $19 million of exposure to the company when it officially filed for Chapter 11 bankruptcy protection in November. The firm has since reclassified its filing as Chapter 7 bankruptcy protection and its assets are currently up for liquidation.

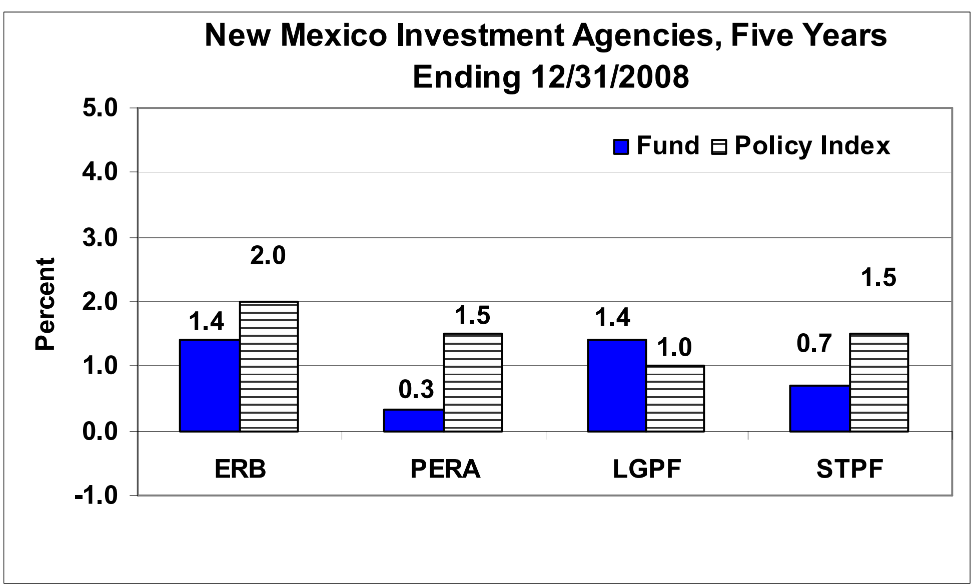
- This quarter's special focus section focuses on third-party marketers and their role in the alternative investment process. HB 876 was passed during the 2009 legislative session in order to increase transparency related to these types of direct investments.

[1] A basis point represents one hundredth (0.01) of one percent. Thus if the LGPF outperformed its benchmark by 40 bps, it outperformed by four tenths of one percent (.40).

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS







FUND ASSET VALUES

Fund asset values continued their severe decline throughout the second quarter of FY09. Total asset values for all funds declined $5.7 billion from the previous quarter and have now fallen $11.4 billion or 30.1 percent throughout the past twelve months. While PERA has fallen the most during the past year suffering a decline of 32.7 percent, the fund suffered the smallest percentage loss during the second quarter. The STPF suffered the biggest fund value decline during the quarter representing a net decrease of 20.6 percent. This decline is of particular concern given that both the LGPF and STPF make annual distributions to the general fund based upon their five-year calendar year end fund values. Although this distribution method mitigates volatility associated with changes in fund values to some extent, a continuation of the sharp decreases the two funds have experienced thus far could have significant impacts on general fund revenues for years to come.

Current Asset Values (millions)
For Quarter and Year Ending December 31, 2008

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (12/31/08)	$ 6,602	$ 8,928	$ 7,853	$ 3,157	$ 26,539
Value Change (Previous Quarter)	(1,384)	(1,798)	(1,684)	(821)	(5,686)
Percent Change	-17.3%	-16.8%	-17.7%	-20.6%	-17.6%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (12/31/08)	$ 6,602	$ 8,928	$ 7,853	$ 3,157	$ 26,539
Value Change (Year Ago)	(2,775.8)	(4,336.3)	(2,844.6)	(1,468.7)	(11,425.3)
Percent Change	-29.6%	-32.7%	-26.6%	-31.8%	-30.1%

*Excludes assets held at STO

ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

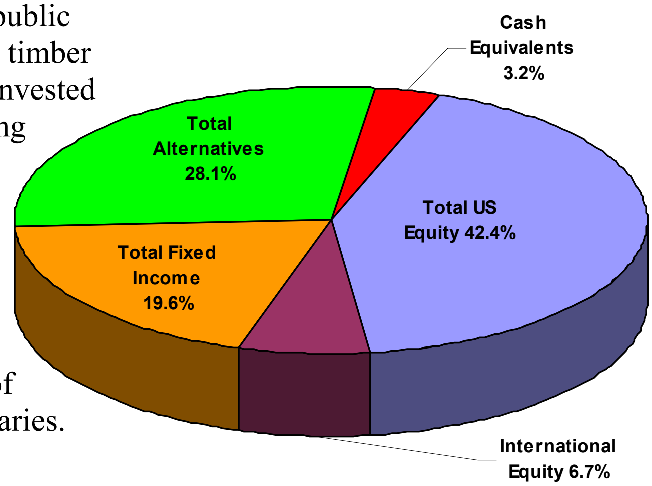
The U.S. economy officially was officially announced to be in recession, and financial markets continued to deteriorate during the second quarter of FY09. In fact the economy was deemed to be in so much trouble in the second quarter that congress passed a $700 billion Troubled Asset Relief Plan (TARP) to help ailing banks mitigate the effects of toxic-assets crowding up their balance sheets. The federal government has since passed an even larger American Recovery and Reinvestment Act (ARRA) aimed at stimulating the economy. The Federal Reserve also attempted to increase liquidity throughout financial markets by bypassing banks and lending directly to U.S. corporations for the first time since the Great Depression. The Federal Reserve then went further to generate liquidity by lowering its target fed funds rate to a historic low of between 0.0 and 0.25 percent.

Financial markets finished calendar year 2008 with historic losses. The Dow Jones Industrial Average (DJIA) fell 33.8 percent, or 4,488.43 points, the NASDAQ index lost 40.5 percent, and the Standard and Poor's 500 (S&P 500) lost 38.5 percent for the twelve months ending December 31, 2008. This twelve month period was also one of the worst years on record for fixed-income markets as well. Aside from Treasuries, which returned approximately 14 percent for the year due to a flight to quality, prices across the board plummeted. For most of the quarter short-term treasury yields were driven to zero, meaning that investors were in essence paying the government to hold their money.

Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries.

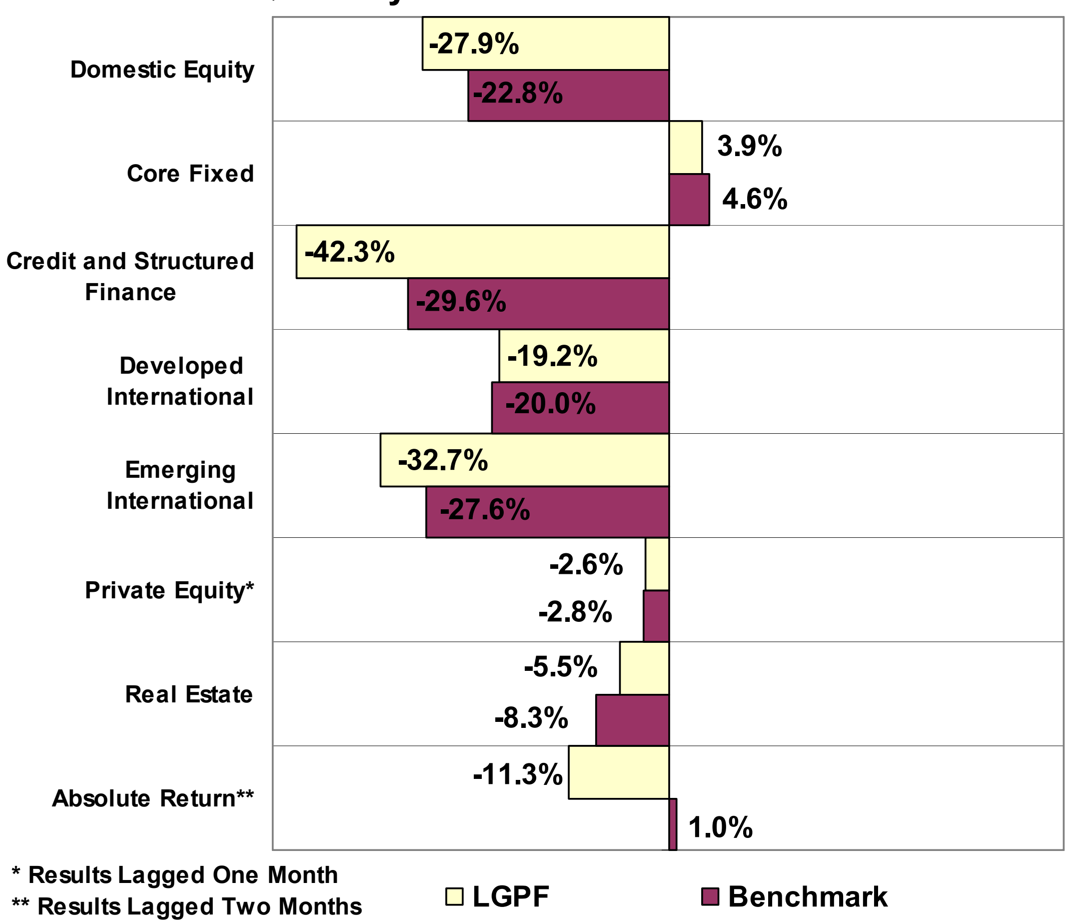
LGPF Asset Allocation as of 12/31/08



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-17.90%	-16.10%	91	-27.40%	-27.10%	61	1.40%	1.00%	57

LGPF Quarterly Performance vs. Benchmarks

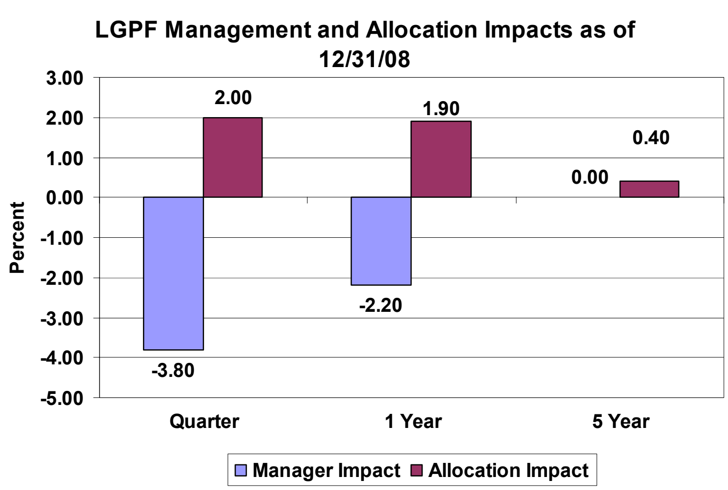


* Results Lagged One Month
** Results Lagged Two Months

Contributing Factors: The LGPF missed its quarterly policy benchmark by 180 bps during the second quarter of FY09. This poor quarterly performance decreased the funds' five year return from 7.2 percent to 1.4 percent. This ranks the funds' performance in the 91st percentile compared with other U.S. endowment funds for the second quarter of FY09 and in the 57th percentile for five-year returns. This is the second consecutive quarter that the LGPF has underperformed its policy benchmark, a sharp contrast to its fourth quarter FY08 performance where the fund outperformed its policy benchmark by an impressive 210 bps.

The funds underperformance of benchmarks is due primarily to its 510 bps underperformance in domestic equity assets. This poor performance was the most crucial due to the asset class' high allocation relative to the rest of the fund. This asset class has been one of the fund's best performers over the past few quarters due to a hedging strategy put into place in mid FY08. This strategy, implemented through derivative contracts constituting a "costless collar," was taken off for most of the quarter due to increased counterparty risk. Because the strategy gives up a portion of the fund's upside in exchange for downside protection, SIC ended up losing out when the collar was put back on in mid-December as the market simultaneously rebounded. The funds other two worst performers were its credit and structured finance assets (CDOs, etc.) underperforming by 1,270 bps, and its absolute return or hedge fund assets which underperformed by 1,140 bps. These assets, the majority of which were intended to serve as a diversified alternative to plain vanilla fixed-income assets, have continuously underperformed throughout the past year. Hedge fund assets in particular may need to be examined as fixed income alternatives, as SIC has consistently underperformed benchmarks based upon fixed income returns despite performing in line with broader hedge fund indices. A review of these assets as acceptable alternatives to standard fixed-income securities may be in order.

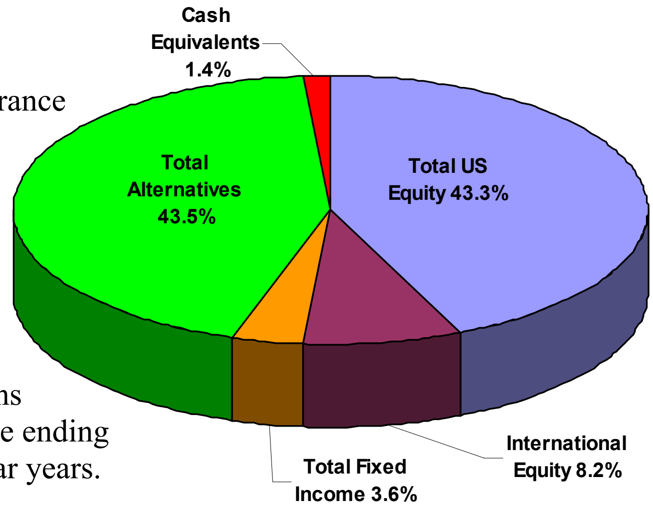
Management and Allocation Impacts: In the second quarter of FY09, active management cost the fund's overall return 380 bps while asset allocation added 200 bps. This marks the second consecutive quarter where active management has been detrimental to the fund's overall return. The magnitude of this quarter's negative performance also caused the one year manager impact to turn negative and brought the five year impact to zero. These impacts are most likely the result of poor external manager performance, which has consistently underperformed SIC internal manager performance throughout the past 12 months.



Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

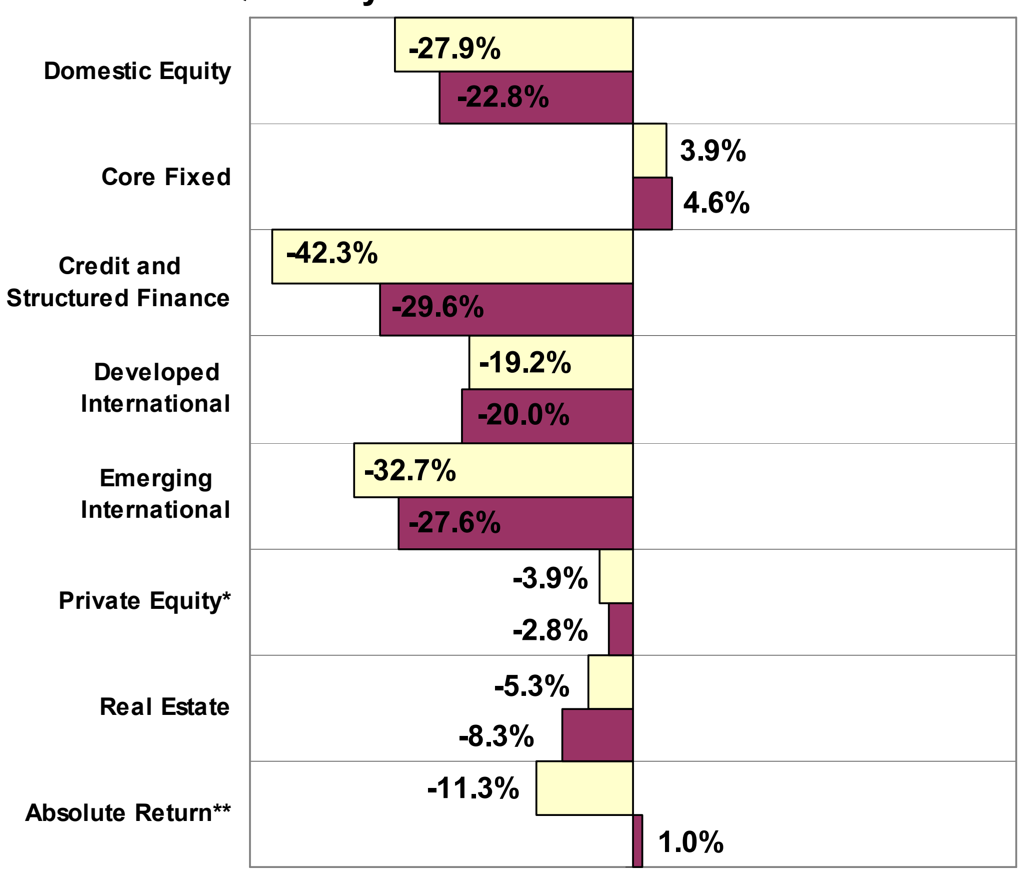
STPF Asset Allocation as of 12/31/08



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-19.50%	-15.70%	94	-29.30%	-26.50%	78	0.70%	1.50%	77

STPF Quarterly Performance vs. Benchmarks

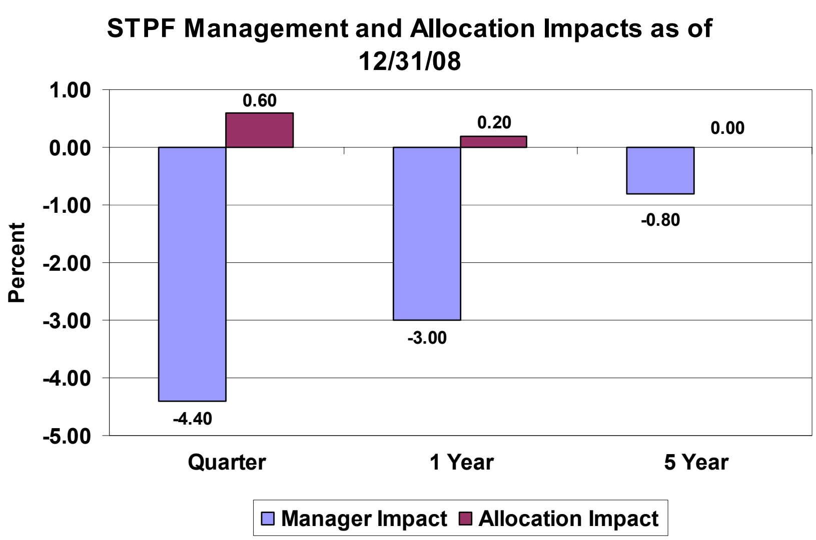


* Results Lagged One Month
** Results Lagged Two Months

Contributing Factors: The STPF underperformed its quarterly policy benchmark by 380 bps during the second quarter of FY09. This brings the fund's one year and five year returns below their policy benchmarks for the first time in a number of years. The majority of the STPF's investments mirror those of the LGPF, however the STPF underperformed the LGPF in the second quarter by 200 bps. The STPF's drastic underperformance relative to the LGPF is due primarily to its high concentration of alternative investments, which have been some of the poorest performers relative to benchmarks. The STPF also currently allocates approximately 6 percent of its portfolio to economically targeted investments (ETI) which are usually differential rate investments. Differential rate investments are authorized by statute as investments intended to stimulate the New Mexico economy despite having a lower than market rate return. The STPF is also home to the New Mexico Private Equity Investment Program (NMPEIP), which has consistently underperformed the SIC National Private Equity Investment Program (PEIP). This caused the STPF to underperform its private equity benchmark by 110 bps whereas the LGPF was able to outperform its private equity benchmark by 20 bps.

Like the LGPF, the STPF holds a number of alternative investments including ETI in its portfolio as a diversified alternative to normal fixed-income securities. These investments have continued to underperform benchmarks and fixed income returns. In the second quarter alone, ETI underperformed its benchmark by 730 bps, absolute return or hedge fund investments underperformed by 1,140 bps, and credit and structured finance investments underperformed by 1,270 bps. A review of these assets as acceptable alternatives to standard fixed-income securities as well as the amount of economic stimulus attributable to ETI may be in order.

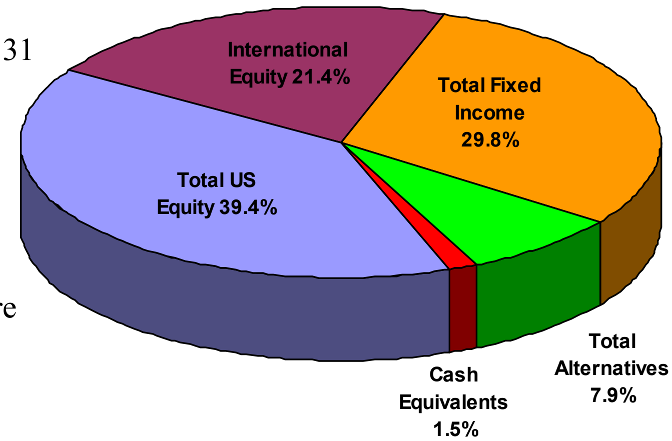
Management and Allocation Impacts: In the second quarter of FY09, active management cost the STPF 440 bps while asset allocation was able to add 60 bps. The allocation impact was 140 bps lower than the LGPF and the management impact was 60 bps lower than the LGPF. The allocation impacts are weaker than the LGPF due to the fund's high alternative investment allocation, discussed in more detail above. The management impacts are most likely the result of poor external manager performance across all major asset classes.



Public Employees Retirement Association (PERA)

Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the "prudent investor rule" and results are reported in the aggregate.

PERA Asset Allocation as of 12/31/08

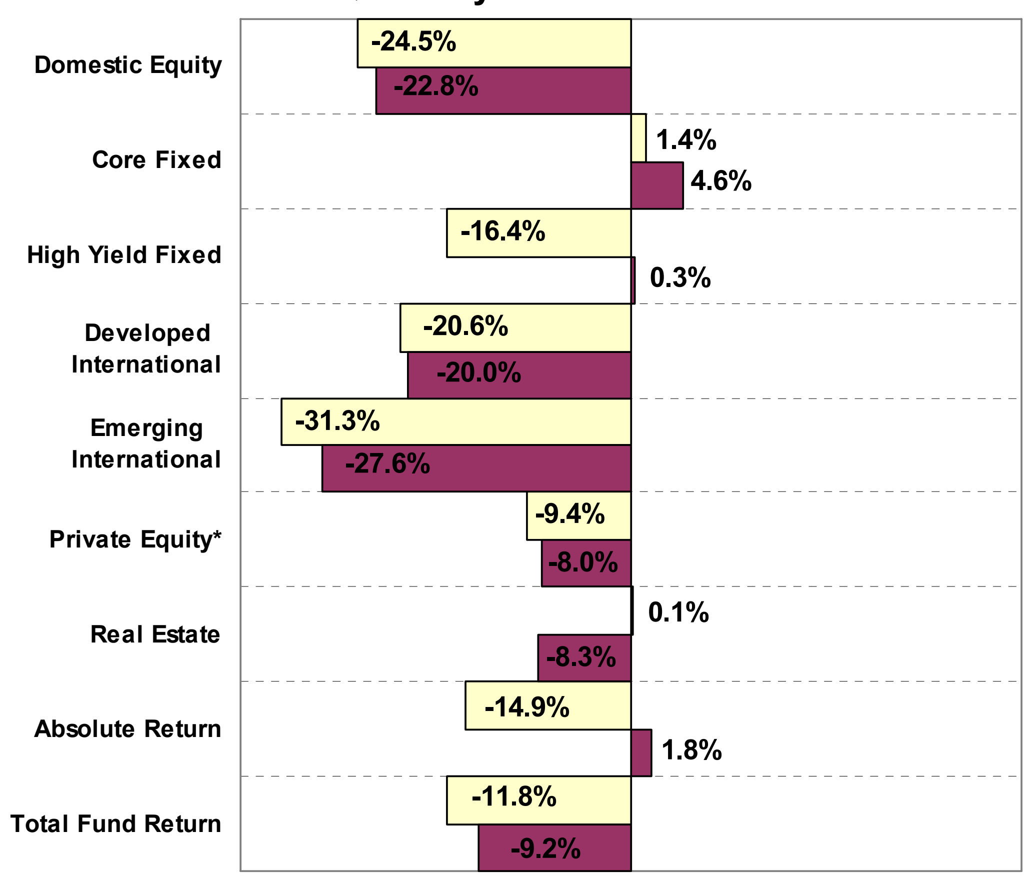


Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-31.96%	-26.47%	99	0.32%	1.5%	97	3.19%	2.49%	60

*PERA also has a long-term 8% actuarial benchmark for funding purposes.

PERA Quarterly Performance vs. Benchmarks

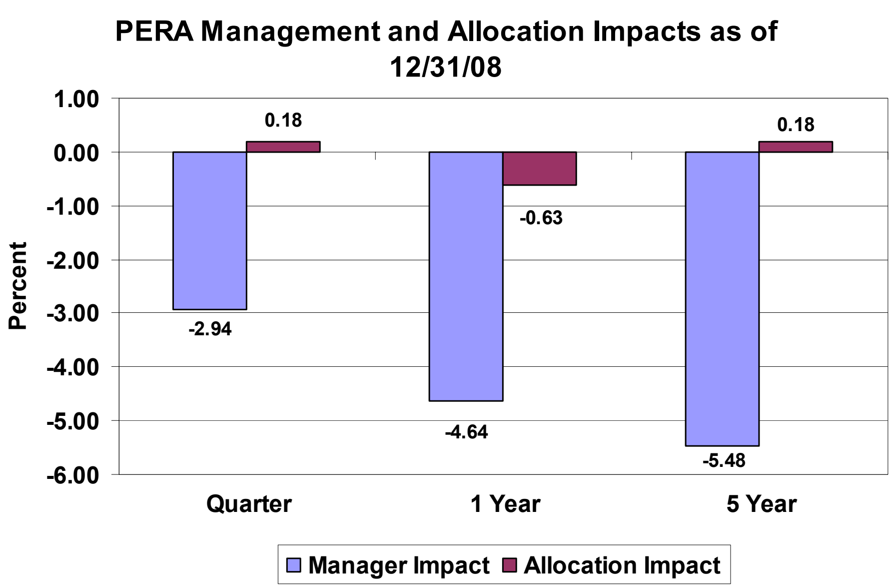


* Lagged One Quarter

Overview: PERA missed its overall policy benchmark by 260 bps for the quarter, placing PERA in the 92nd percentile of public funds for this period. The one-year underperformance of 549 bps dropped the fund's five-year returns to 0.32 percent, 118 bps below its policy benchmark. This puts the fund in the 99th percentile of all public funds for the past twelve months. The decline in the 10-year return to 3.19 percent is a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits.

The primary reason for the fund's significant underperformance is its large exposure to international equity investments. PERA currently has the highest international equity allocation of all state investment agencies by a significant margin. This strategy proved extremely advantageous throughout the middle part of the decade when international equity investments, particularly those in emerging markets, consistently provided double digit returns to investors. In the past year however, most international equity indexes have fallen by more than 45 percent and PERA's overall international equity composite has fallen by more than 46 percent. In addition to the overall sector downturn, external equity managers have consistently underperformed relative benchmarks, causing the fund to underperform quarterly benchmarks in developed and emerging international equity investments by 60 and 370 bps respectively. In order to ensure the long-term viability of the fund, PERA may need to review its target portfolio allocation particularly its equity exposure.

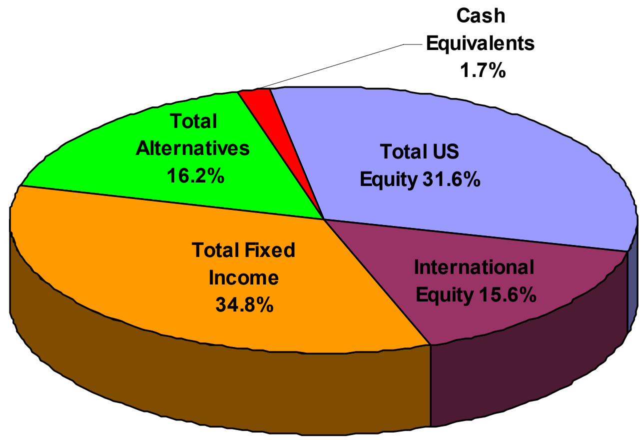
Management and Allocation Impacts: Active management cost PERA nearly 300 bps in the second quarter of FY09. This is not a new trend, as active management has consistently hurt PERA returns due to underperforming external investment managers. Over the past five years active management has cost the fund 548 bps, while its portfolio allocation has only added back 18 bps. Although PERA has taken steps to address the problem, more must be done in the future to recruit and retain good external asset management. PERA and its advisors must address this problem more effectively, even if it requires moving some of PERA's assets from actively managed investments into indexed investments.



Educational Retirement Board (ERB)

Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the "prudent investor rule" to ensure retirement benefits. As of June 30, 2008, ERB had 31,192 retirees and 63,698 active members.

ERB Asset Allocation as of 12/31/08

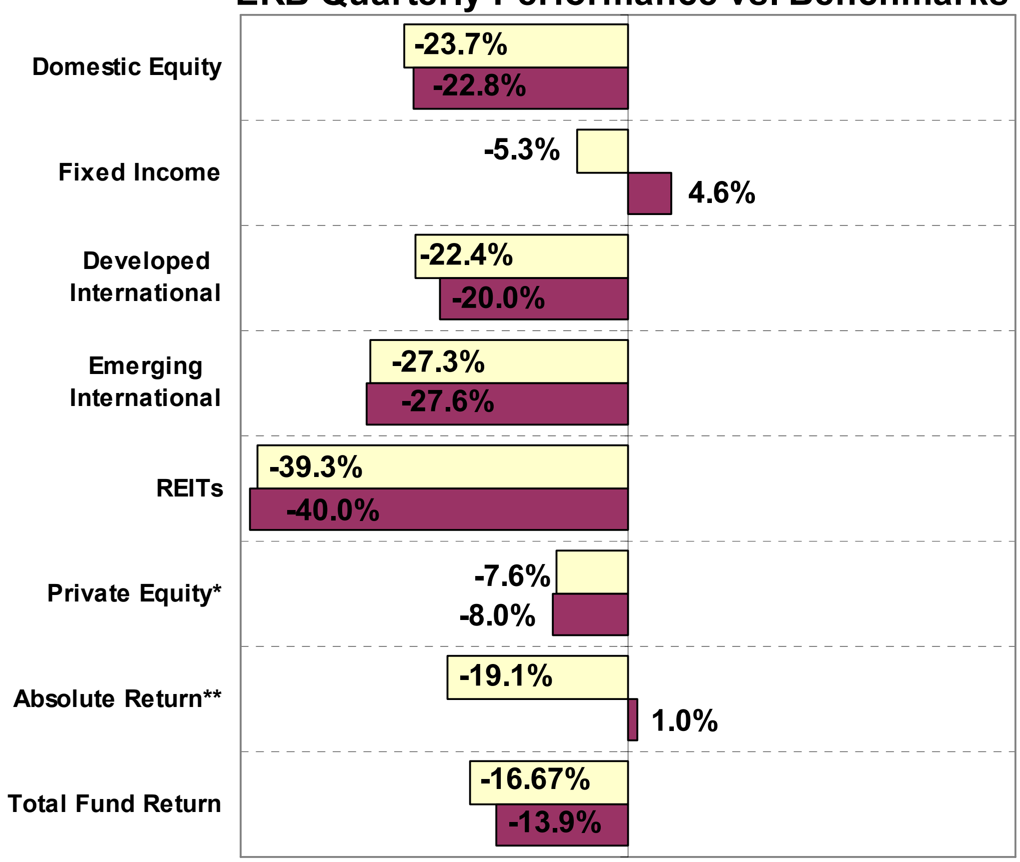


Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-28.1%	-25.8%	85	1%	2%	71	1.8%	2.3%	94

*ERB also has an 8% actuarial benchmark for funding purposes.

ERB Quarterly Performance vs. Benchmarks

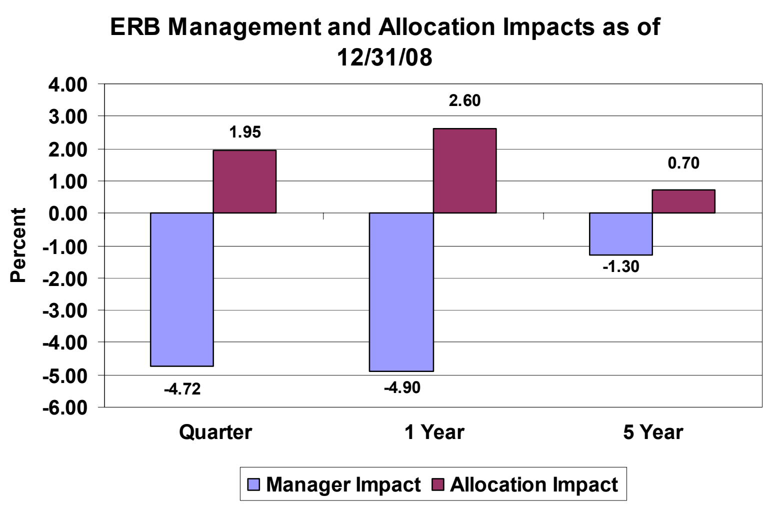


* Results Lagged One Month
** Results Lagged Two Months

Overview: ERB missed its quarterly policy benchmark by 277 bps and has underperformed its 12-month benchmark by 230 bps. The fund's ranking versus other U.S. public funds dropped considerably in the second quarter. The fund's quarterly results place it in the 97th percentile of U.S. public fund returns, and its ten year ranking has now fallen into the 94th percentile. The decline in the 10-year return to 1.8 percent is a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits.

The fund's two worst performing asset classes relative to benchmarks throughout the quarter were fixed-income and absolute return or hedge funds. The fund's hedge fund assets underperformed their benchmark by a staggering 1,920 bps. While this poor performance is alarming, it was the fund's underperformance in fixed income that contributed most to the fund's overall underperformance. Fixed income assets, which made up nearly 35 percent of the total fund at the end of the second quarter, underperformed relative benchmarks by 990 bps. The underperformance stems primarily from the fund's high yield fixed income exposure and investments in distressed credit funds managed by the Pacific Investment Management Company (PIMCO) and Western Asset Management Company (WAMCO). The WAMCO fund was not originally intended to be a distressed asset fund, however due to its over-allocation to mortgage backed securities it has in essence become one. ERB intends to unwind its position in WAMCO, once the fund's assets become more liquid. Both the PIMCO and WAMCO funds underperformed the Barclay's Aggregate Index (BC Aggregate, formerly the Lehman Brothers Aggregate Index) by 680 and 1,660 bps respectively. Without the poor performances by the aforementioned investments, ERB would have been much more in line if not ahead of its quarterly policy benchmark.

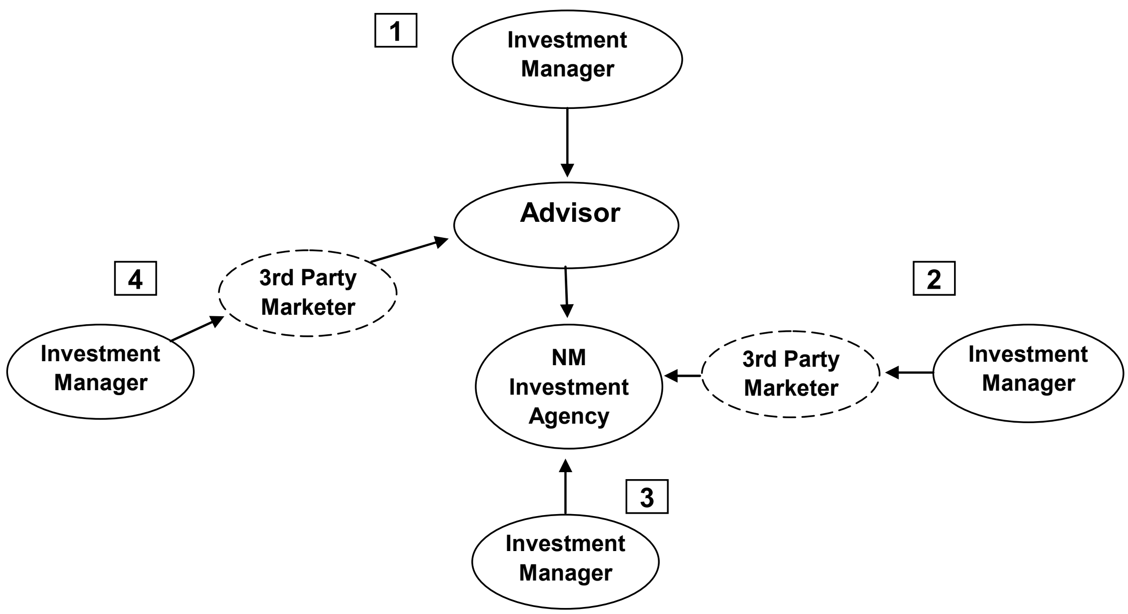
Management and Allocation Impacts: ERB was able to add 195 bps due to its asset allocation in the second quarter. By under allocating both domestic and international equity investments relative to policy targets, the fund was able to limit its exposure to two of the worst performing asset classes over the past year. This conservative approach has now saved the fund more than 260 bps for the year. However, manager performance, normally a plus for the fund, has fallen off sharply over the past 12 months. Fixed-income manager performance in particular has hurt the fund, due primarily to the types of fixed-income assets being held by those managers. Calendar year 2008 was one of the worst in history for high-yield and distressed fixed income assets.



SPECIAL FOCUS: 3rd Party Marketers and Their Role in Alternative Investments

After the enactment of the Prudent Investor Act in 2005 all state investment agencies, with the exception of the State Treasurer's Office, began to move aggressively into a variety of alternative investments. These types of investments, (hedge funds, private equity funds, collateralized debt obligations, etc.) typically require a direct investment with a fund manager as opposed to an open-market purchase through a broker. In order to raise sufficient capital for investment, many of these fund managers utilize third-party marketers, which have become quite common throughout the investment world. According to the Third-Party Marketers Association, third-party marketers "assist in increasing institutional assets for their…investment manager clients." They have become necessary due to the long and at times arduous process of soliciting a direct investment of public money. Figure 1 shows four methods of soliciting a direct investment of public money.

Figure 1: Four Methods of Soliciting Direct Investment



Method one shows an investment manager going through an advisor in order to solicit an investment from a state investment agency. The use of advisors is extremely common when dealing with such specialized assets and currently all of the state investment agencies utilize advisors for the majority of their alternative investments. Advisors apply an extra layer of due diligence to these complex assets and can serve to filter out poor investments before they reach state investment staff. Although a third-party marketer circle is not included in method one, one can be present in these types of scenarios by advising the investment manager on how to contact and present to the advisor and or state investment staff.

Method two shows a scenario in which an investment manager directly utilizes a third-party marketer. In this instance the investment manager is using the third-party market to contact and solicit investments from state investment staff without going through an advisor. This method is more common for debt instruments such as collateralized debt obligations (CDO) than for private equity or hedge funds.

Method three shows an investment manager soliciting investment directly from the state investment agency at a staff level. This approach is once again more in line with debt instruments than with private equity or hedge funds. Method three is similar to method one in that it does not include direct participation with state investment staff by a third-party marketer, however a third-party marketer may be advising the investment manager on how to proceed throughout the investment process.

Method four is most common among private equity and hedge funds. The investment manager in this scenario is directly utilizing a third-party marketer and going through an advisor. If the advisor, after applying thorough due diligence, agrees that this type of investment may be in the best interest of the state investment agency, then the third-party marketer may also be in contact with state investment staff.

This issue has recently received national attention after the 123-count indictments of two former aides to the former New York State Comptroller. The charges, which have been accompanied by a formal SEC complaint, stem from alleged pay-to-play schemes involving third-party marketers and the state's pension fund. Involved with the investigation is Aldus Equity Partners, which advises both SIC and ERB as a private equity advisor. The SEC complaint alleges that Aldus, acting as a fund of funds investment manager, paid third-party marketers who then made contributions or donations to political candidates. Aldus is <u>not</u> listed as a defendant in the case, and is currently not suspected by authorities of any criminal or fraudulent activity.

House Bill 876, which was passed during the recently ended 2009 legislative session, incorporates additional transparency in the alternative investment process by requiring investment managers seeking the investment of state funds disclose the use of third-party marketers. The bill states that the State Investment Council (SIC), the Public Employees Retirement Association (PERA), and the Educational Retirement Board (ERB) are prohibited from making investments in assets other than "publicly traded equities or publicly traded fixed-income securities" unless the recipient of the investment discloses the use of any third-party marketers and how they are being compensated. As a result, any person who "knowingly withholds" this information would be guilty of a fourth degree felony. As of the publication of this report, House Bill 876 is still awaiting the Governor's signature.